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Generating Precedent in Securities Industry Arbitration

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The author charts the progress made by the securities industry's dispute resolution system as it went from judicial litigation to a system that relies almost exclusively on arbitration. Further advances were made by the adoption of the 1989 Rules Amendments, which, by introducing prehearing conferences and setting deadlines for document exchanges, cleared up many procedural issues. However, one serious problem remains: The present system does not provide a means to generate case precedent. The author suggests various ways to cure this defect.

The Transformation of Securities Industry Dispute Resolution

In the late 1980s, broker/customer adjudication within the securities industry was transformed from a dispute resolution system that was heavily dependent on judicial litigation to an adjudicatory system that significantly relies on arbitration. This transformation in securities industry adjudication occurred as a result of two United States Supreme Court decisions: *Shearson/American Express Co. v.*

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McMahon[1] in 1987 and *Rodriguez de Quijas v. Shearson/American Express Co.*[2] in 1989. These two cases, effectively and literally, overturned a thirty-year precedent that had permitted customers, when in dispute with their brokerage firms, to pursue their remedies in court, notwithstanding the fact that such customers might have previously executed mandatory predispute arbitration agreements.[3] As a consequence of this reversal, a relatively modest arbitration system that had initially been promoted by the Securities and Exchange Commission (SEC) as a consumer protection device for small investors[4] underwent extraordinary growth in staff,[5] budget, and case load.[6]

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[1] 482 U.S. 220 (1987).

[2] 109 S. Ct. 1917 (1989).

[3] The genesis of this precedent was the U.S. Supreme Court decision of Wilko v. Swan, 346 U.S. 427 (1953). In *Wilko*, the Court held that the legislative goal embodied in the Securities Act of 1933 of protecting investor rights and forbidding a waiver of those rights overrode the legislative policy found in the Federal Arbitration Act of 1924 of promoting arbitration as an alternative to litigation. *Id.* at 438.

[4] When the SEC's Office of Consumer Affairs proposed the creation of a uniform system of arbitration for customer/broker disputes, it advised that when the investor has "a substantial amount of money at stake, the investor will view litigation as a reasonable course to pursue." But neither the then-existing arbitration system nor litigation was perceived as providing the investor with a small amount of money at stake with an "economical, expeditious procedure for the resolution of that dispute." Exchange Act Release No. 12,974 [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,807 at 87,105 (Nov. 15, 1976). The SEC identified its motivation in encouraging the adoption of a uniform code of arbitration as a "concern that there be more effective, efficient, and economical dispute resolution procedures available to individual investors." Exchange Act Release No. 13,470 [1977–1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,136 at 87,905 (Apr. 26, 1977).

[5] For example, the staff of the Arbitration Office of the NASD grew from nine to seventy-four between 1980 and 1989. Letter to David A. Lipton from NASD Deputy Director of Arbitration Kenneth Andrichick (July 3, 1990).

[6] The composite figure for arbitration cases annually concluded by those self-regulatory organizations (SROs) that conduct arbitration increased between 1980 and 1988 from 686 cases to 3,340 cases. *Sixth Report of the Securities Industry Conference on Arbitration* 4 (Aug. 1989) (hereinafter *SICA Report 6*). In 1989, the NASD, the administrator of the largest securities industry arbitration program, increased the number of cases concluded in a year to 4,050 from 2,169 the previous year. The number of cases received in 1989 by the NASD, however, declined somewhat in 1989 to 3,651 from 3,990 the previous year. Conversations between

Concerns Remaining After the Transformation

The securities industry dispute resolution system did not emerge problem-free from its metamorphosis.[7] The greatly expanded use of the arbitration system has placed intensified pressures on the self-regulatory system to correct the system's deficiencies. While dissatisfied users of the arbitration system were once able to walk away from predispute arbitration agreements and take their disputes to judicial litigation, this is no longer the case. For customers who have signed a predispute arbitration agreement, arbitration provides the only recourse for dispute resolution, regardless of the amount in controversy or the complexity of the issues involved. Because of the mandatory nature of the arbitration system,[8] it is more critical that the system maintain performance standards commensurate with user expectation.

David A. Lipton and NASD Deputy Director of Arbitrations Kenneth L. Andrichik (June 27, 1990).

[7] Some of the concerns that exist relating to the nature of arbitration include (1) limitations of the discovery process; (2) the absence of written reasoned arbitrator opinions and the impact of such limitation upon the ability of the parties to bring an appeal; (3) the lack of guidance in the current arbitration system regarding the administration of multiparty and class action controversies; (4) the appearance of potential conflicts in respect to the securities industry's administration of a dispute resolution system created to resolve conflicts involving securities industry personnel; (5) uncertainties regarding the standards of admissibility of evidence; and (6) questions regarding the experience and training of the arbitrators.

[8] Shortly after the *McMahon* decision, note 1 *supra*, the SEC's Division of Market Regulation conducted a survey to determine how often brokers require commitments from their customers to settle disputes by binding arbitration. SEC Division of Market Regulation, *Summary of Staff Findings With Respect to the Use of Predispute Arbitration Clauses* (undated) (hereinafter *SEC Arbitration Clause Study*), Reported in 1 Arbitration Commentator, July 1988, at 6. The survey examined the practices of sixty-five broker-dealers, including twenty-five of the largest member firms of the NYSE and the twenty largest member firms of the NASD that are not NYSE members. The study found that 96 percent of the margin accounts held by firms offering such accounts were covered by predispute arbitration clauses. Some 95 percent of the retail options accounts held by firms that permit such options accounts were covered by arbitration agreements. The survey found, however, that in the instance of cash accounts, only 39 percent of such accounts were covered by arbitration agreements. *Id.* at 1–2. While the percentage of cash accounts covered by mandatory arbitration provisions is far less than the percentage covering options and margin accounts, fewer legal problems arise typically in the former type of account than in the latter.

Concerted efforts of the Securities Industry Conference on Arbitration (SICA),[9] individual self-regulatory organizations (SROs), and the SEC led to the adoption in 1989 of a large number of rule changes (the 1989 Rules Amendments) that promise to significantly advance the quality of securities arbitration.[10]

Improvements Made by the 1989 Rule Changes

Document Exchange and the Prehearing Conference

One of the findings that emerged from a 1987 study of the securities industry arbitration system, sponsored by the National Institute of Dispute Resolution and conducted by this author, was that the single greatest problem confronting practitioners in arbitration was the nonreceipt of documents during discovery.[11] This dissatisfaction

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[9] SICA is a securities industry task force, established in 1977, that developed and continues to update the uniform arbitration code. This code has been substantially adopted by the various SROs that conduct arbitration. SICA is composed of ten representatives of the SROs, one representative of the Securities Industry Association (SIA), and four public representatives. *SICA Report 6,* note 6 *supra,* at 1.

[10] In September 1987, the director of the SEC's Division of Market Regulation sent a thirteen-page, single-spaced letter (hereinafter *SEC Recommendation Letter)* to the various SROs that conduct arbitration as well as to the SICA. The *SEC Recommendation Letter* suggested changes to be made in the securities industry's arbitration code in regard to, among other matters, discovery issues, qualification of arbitrators, disclosure of the background of arbitrators, written arbitration awards, publication of such awards, and prehearing conferences. In response to the *SEC Recommendation Letter,* as well as to proposals made by Congress and state legislatures, SICA made extensive changes in its uniform code. *SICA Report No. 6,* note 6 *supra,* at 2. More significantly, the SROs that conduct arbitration submitted rule changes to the SEC dealing with many of the matters raised in the *SEC Recommendation Letter*. These rule changes were approved by the SEC in May 1989. Exchange Act Release No. 26,805 (May 10, 1989) [1989 Transfer Binder] Fed. Sec. L. Rep. ¶ 84,414 (hereinafter 1989 Rules Amendments Adoption Release).

[11] See Lipton, "Discovery Procedures and the Selection and Training of Arbitrators: A Study of Securities Industry Practices," 26 Am. Bus. L.J. 435 (1988) (hereinafter *Lipton Arbitration Study*). Based on a limited sample of attorneys who regularly served clients in securities industry arbitration, the study found that in the vast majority of instances where such attorneys expressed a concern with the operation of the arbitration system, that concern involved the discovery process. *Id.* at 461.

with the discovery process existed prior to the 1989 Rules Amendments, notwithstanding the fact that the arbitration codes of the various SROs contained a variety of provisions for the voluntary and mandatory exchange of documents.[12] The pre-1989 rules, however, did not specify a timetable for the exchange of documents. The absence of such a timetable encouraged delays in the production of documents by the parties. Also, because there were no fixed timetables for the transfer of documents, it was often not clear whether a party had determined not to transfer documents or was merely tardy in transferring them.

One of the arbitration Rules Amendments adopted in 1989 directly responded to this lack of discovery deadlines. Rule 32(b)(2) now requires satisfaction of or objection to document requests within thirty days of receipt of such requests.[13] This timetable provision dovetails into another innovation of the 1989 Rules Amendments—the prehearing conference. The 1989 Rules Amendments provide that disagreements among parties as to document delivery may, upon written request, be referred to a prehearing conference or to a single public arbitrator selected by the director of arbitration from the arbitration panel.[14] Informal statistics gathered by the National Association of Securities Dealers (NASD) arbitration staff

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[12] See generally *Lipton Arbitration Study,* note 11 *supra,* at 456–459. As an example of the methods available under the pre-1989 rules (as well as the post-1989 rules), it is instructive to examine the arbitration rules of the largest securities arbitration forum, the NASD. Document discovery was and is provided for within several sections of the NASD's Code of Arbitration Procedure (CAP). When citing to the NASD's CAP, reference is made to the version that exists after the amendments made in 1989 (hereinafter NASD CAP). NASD CAP § 32(b) requires voluntary exchange of documents. NASD CAP § 33(a) empowers arbitrators to issue subpoenas as provided by applicable law. NASD CAP § 33(b) empowers arbitrators to direct persons employed by or associated with the NASD to produce records within possession or control of such person.

[13] NASD CAP § 32(b)(2). This section reads:

> Unless a greater time is allowed by the requesting party, information requests shall be satisfied or objected to within thirty (30) calendar days from the date of service. Any objection to an information request shall be served by the objecting party on all parties and filed with the Director of Arbitration.

[14] The authority for scheduling a prehearing conference upon the written request of a party or an arbitrator or at the discretion of the director of arbitration was created by NASD CAP § 32(d)(1), adopted in the 1989 Rules Amendments. The director of arbitration was also authorized by NASD CAP § 32(e) to appoint a single member of the arbitration panel to decide unresolved issues. NASD CAP §

suggest that some form of prehearing consultation with an arbitrator or a panel of arbitrators is now conducted in 90 percent of the matters going to hearing.[15] It is possible that additional educational efforts will be needed in order to encourage the parties to arbitration to rely more routinely on voluntary compliance with the document exchange rules and to resort less frequently to prehearing conferences as a means of achieving compliance with the document exchange schedule mandated by the rules.

The Prehearing Conference, the Single Arbitrator in the Prehearing Mode and Depositions

The prehearing conference mechanism, as well as the use of a single arbitrator serving in a prehearing mode, are innovations of the 1989 Rules Amendments.[16] The prehearing conference is designed to seek agreement among the parties on any issues that relate to the prehearing process or to the hearing, including but not limited to the exchange of information, exchange or production of documents, identification of witnesses, identification and exchange of hearing documents, stipulation of facts, identification and briefing of contested issues, and any other matters that will expedite the arbitration proceedings.[17]

The single arbitrator serving in a prehearing mode is authorized to

> act on behalf of the panel to issue subpoenas, direct appearances of witnesses and production of documents, set deadlines for compliance, and issue any other rulings which will expedite the arbitration proceedings.[18]

The purposes for which the prehearing conference and the single arbitrator serving in the prehearing mode are designed include a

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32(e) was adopted in the 1989 Rules Amendments. Unsatisfied written requests for information may be referred by the director of arbitration, pursuant to NASD CAP § 32(b)(4), to a prehearing conference created pursuant to NASD CAP § 32(d), or to a single arbitrator selected under NASD CAP § 32(e).

[15] This informal estimate was made by Director of Arbitration Deborah Masucci in a discussion with David A. Lipton (Apr. 1990).

[16] NASD CAP §§ 32(d)(1), 32(e).

[17] NASD CAP § 32(d)(1).

[18] NASD CAP § 32(e).

number of discovery functions other than document production. While the arbitration rules do not specifically address the authority of arbitrators to grant depositions, the regulatory history of the rules indicates that they were intended to include such authority. The availability of depositions through the prehearing mechanism is an important enhancement to the arbitration rules. Information suggests that the nonavailability of depositions in arbitration discovery was the one area in the arbitration process in which practitioners most wanted to see some expansion in the rules.[19] The term "deposition" is not mentioned in either the rule dealing with prehearing conference or in the rule authorizing the use of the single arbitrator in the prehearing mode. The prehearing conference rule, however, does authorize the presiding person at the conference to "seek to achieve agreement among the parties on any issue which relates to the prehearing process or the hearing, including . . . matters which will expedite the arbitration process." Similarly, single prehearing arbitrators may issue rulings to "expedite the arbitration proceedings." When the 1989 Rules Amendments were adopted, the SEC advised in its promulgating release that its approval of the amendments to the discovery rules was based on its clear understanding that "depositions will now be available as a matter of routine to parties in appropriate cases."[20] The SEC indicated that pursuant to the new rules, depositions could be used not only for the preservation of the testimony of ill, dying, or distant witnesses but also for the expedition of the large and complex cases.[21] *The Arbitrator's Manual,*[22] which was compiled by SICA as a guide to arbitrators, published by the SROs in 1989, and supplemented later that year, supports the SEC's interpretation of the new prehearing conference rule in regard to depositions. *The Arbitrator's Manual,* as supplemented, in explaining the arbitration code, advises:

> Access to depositions should be granted to preserve the testimony of ill or dying witnesses, or of persons who are unable or unwilling

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[19] See *Lipton Arbitration Study,* note 11 *supra,* at 461–462.
[20] 1989 Rules Amendments Adoption Release, note 10 *supra,* at 80,108.
[21] *Id.*
[22] SICA, *The Arbitrator's Manual* (1989).

to travel long distances for a hearing . . . , as well as to expedite large or complex cases. [Emphasis added.][23]

As a practical matter, depositions are being ordered by arbitrators relatively infrequently.[24] When a deposition is ordered, it is typically because a witness would otherwise be unable to attend the hearings. At present, depositions are not typically ordered for purposes of clarifying issues prior to the hearings or for purposes of eliminating unnecessary testimony at the hearing—purposes that might be labeled as "procedural efficiency." As the experience of the arbitrators grows, it is possible that a broader use will be made of this discovery mechanism beyond that of ensuring witness accessibility. It might be possible that an SRO rule change will be required to encourage the occasional use of depositions for procedural efficiency. Any steps in this direction will have to be balanced against the risks of an excessive "proceduralization" of arbitration.

Other Functions of the Prehearing Conference

The prehearing conference procedure was designed to accomplish more goals than resolving document exchange disputes and occasionally ordering depositions. *The Arbitrator's Manual* also suggests the use of prehearing conferences for encouraging the parties to order the appearance of parties, set deadlines, enter into stipulations, narrow the issues in dispute, identify witnesses and the subject of their testimony, and identify documents to be used at the hearing.[25] In addition, the prehearing arbitrator is advised to consider the desirability of having briefs or memoranda prepared and to consider issues of consolidation, severance, and location of the hearing.[26] If the prehearing arbitrator seeks the advice of colleagues, a full prehearing conference may be convened.[27] At the present time, the prehearing conference and the prehearing arbitrators are being used

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[23] *Id.* at 2 (supp.) (emphasis added).

[24] This assessment of the use of depositions by arbitrators was made by NASD Director of Arbitration Deborah Masucci in discussions with David A. Lipton (Apr. 1990).

[25] *The Arbitrator's Manual*, note 22 *supra*, at 9–10.

[26] *Id.* at 10.

[27] *Id.*

primarily to ensure timely document production, order the appearance of parties, and occasionally order responses to interrogatories.

Evaluation of the Prehearing Conference

Considering the frequency with which the prehearing conference and prehearing arbitrators have been used since the approval of the 1989 Rule Amendments, it should be possible to evaluate the success of the prehearing conference program. It will be necessary to gather and compile statistics relating to the efficiency of the program. A central question that must be asked is: Has the program resulted in an overall reduction or an expansion of time expended by the parties, their counsel, and by the staff to arrive at closure of matters in arbitration? Efforts should also be made to evaluate the far more difficult question of whether the staff, parties, and party representatives perceive the prehearing conference as having enhanced the potential for the arbitration process to identify and analyze fairly the relevant issues arising out of the matters in arbitration. In other words, has the prehearing conference been not merely efficient in saving time but also efficient in facilitating a probative examination of the matters in controversy.

Other Matters Changed by the 1989 Rules Amendments

Concerned with the classification of "public" and "industry" arbitrators,[28] the 1989 Rules Amendments specify who may not serve as a public arbitrator and who may serve as an industry arbitrator.[29]

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[28] Under the arbitration rules, panels of three or more arbitrators must be composed of a majority of nonindustry arbitrators (unless the public customer otherwise requests). NASD CAP § 19(a).

[29] For example, an arbitrator is designated as being from the securities industry if he is an attorney, accountant, or other professional who has devoted 20 percent or more of his professional work effort to securities industry clients within a prior two-year period. NASD CAP § 19(c)(4). A person is designated a public arbitrator if he is not from the securities industry. Further, a person may not be designated as a public arbitrator if he has a spouse or other member of the household who is associated with a broker-dealer. NASD CAP § 19(d).

Complementing the new arbitrator classification provisions is a disclosure requirement that, on a timely basis, provides to users of arbitration information concerning the background of the arbitrators chosen for a hearing.[30] The 1989 Rules Amendments also responded to the lack of availability of public information concerning the outcome of arbitration matters by designating an expanded content of the written award[31] and by mandating public accessibility to such awards.[32]

Residual Problems With the Arbitration System

Reflecting on the variety as well as the utility of the 1989 Rules Amendments, it becomes apparent that *McMahon* and *Rodriguez* affected only the first of two revolutions in the arbitration system. The revisions of the arbitration rules have essentially affected the second revolution. Notwithstanding the number and scope of the 1989 Rules Amendments, some design inadequacies remain within the current arbitration system. For example, uncertainty exists as to when joinder of claims is appropriate and when class actions are appropriate. In addition, there is a need to enhance the educational program of the pool of arbitrators both as to procedural as well as substantive matters. Also, a number of commentators have begun to suggest that securities industry arbitration should be administered by an independent, nonindustry body.[33] Finally, a major concern is

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[30] Parties to arbitration will receive the arbitrator's ten-year employment history as well as other pertinent information at least eight business days prior to the date set for the first hearing session.

[31] NASD CAP § 41(e) requires that the award

> contain the names of the parties, a summary of the issues in controversy, the damages and other relief requested, the damages and other relief awarded, a statement of other issues resolved, the names of the arbitrators, the date the claim was filed and the award rendered, the number and dates of hearing sessions, the location of the hearings, and the signature of the arbitrators concurring in the award.

[32] NASD CAP § 41(f) requires that all awards involving public customers, excluding the names of the arbitrators, be made publicly available.

[33] See, e.g., Katsoris, "The Level Playing Field," 17 Fordham L. Rev. 419, 472–477 (1990). Both the SIA and the NASD have indicated their support of a unified arbitration system. "SIA Calls for Single Agency to Administer Arbitration," 11 Sec. Reg. L. Rep. 13 (Jan. 5, 1990); "NASD Backs Single Arbitration Forum," 22 Sec. Reg. L. Rev. 191 (1990).

the limited ability of the arbitration system, as it is currently constituted, to generate case precedent in regard to substantive securities law issues.

The Inability of the Arbitration System to Generate Precedent

Securities law, and particularly that aspect of securities law that governs the relationship between brokers and customers, is not static. New products, new trading strategies, new brokerage firm operations, and the increased resort to arbitration itself are phenomena that can potentially generate a need for changes in the law governing broker/customer disputes. How will such changes in the law be developed within the arbitration system? What mechanism will signal when change is necessary? What mechanism will determine how such changes should be structured?

Although the securities arbitration rules require written awards, the awards, even after the 1989 Rules Amendments, need not include reasons, whether legal or otherwise, for the findings incorporated within the award.[34] In addition, even when an arbitration panel writes a reasoned opinion, the arbitration rules do not bestow any precedent value on arbitrator opinions. Since securities arbitration does not require reported reasoned opinions with precedent value, the system cannot generate its own legal guidance to respond to changes in products or operations of the securities industry.

Historically, even though arbitrators have not been bound by case precedent,[35] arbitrators, as well as the attorneys for the parties to arbitration, make reference to administrative as well as case law to obtain legal guidance. With the arbitration system all but supplanting

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[34] The arbitrators' award need only include objective information, such as the amount in controversy, the amount awarded, and the issues in controversy. NASD CAP § 41(e). See note 31 *supra* for a more complete text of this provision.

[35] *The Arbitrator's Manual,* note 22 *supra,* at 19, advises as follows:

> Arbitrators are not strictly bound by case precedent or statutory law. Rather, they are guided in their analysis by the underlying policies of the law and are given wide latitude in their interpretation of legal concepts. On the other hand, if an arbitrator manifestly disregards the law, an award may be vacated.

the judiciary as the means of resolving broker/customer controversies, there is less and less opportunity for judicial interaction in broker/customer disputes and a significant reduction in judicially generated case precedent. Some precedent continues to be generated by SEC administrative decisions, but this body of law arises out of disciplinary actions and does not entirely mirror the concerns of nongovernment parties in controversy. Consequently, the precedential value of SEC administrative decisions is somewhat limited.

For example, the SEC's administrative decisions do not focus on means of measuring damages between private litigants, nor are they always based on the same statutory provisions upon which private litigation will be fought (the SEC can bring administrative actions based upon statutory provisions for which no private remedy exists). It has reported judicial decisions that have been most valuable to arbitrators in determining applicable law.

The Need for Case-Generated Precedent

A number of examples readily come to mind of situations in which the old precedents are no longer relevant and arbitrators require new guidance in order to respond to changing aspects of the securities industry. The following are only three examples:

Example 1. From case analysis, we know that to prove a churning claim, the presence of three elements must be shown: (1) the account was controlled by the broker; (2) the trading was excessive for the objectives and resources of the customer; and, frequently, (3) the broker acted intentionally.[36] Over the past several decades,

[36] Arceneau v. Merrill Lynch, Pierce, Fenner & Smith, 767 F2d 1498, 1501 (11th Cir. 1985); Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413, 1416–1417 (11th Cir. 1983); Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980); Miley v. Oppenheimer & Co., 637 F.2d 318, 324 (5th Cir. 1981); Rolf v. Blyth, Eastman, Dillon & Co., 424 F. Supp. 1021, 1039–1040 (S.D.N.Y. 1977), *aff'd*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). Willful and reckless disregard for the interests of the customer is at times cited as a subsititute for broker intentionality. Hatrock v. Edward D. Jones & Co., 750 F.2d 767 (9th Cir. 1984).

the courts have developed several criteria for evaluating the second of those three elements—excessive trading. The most frequently utilized measurements are the turnover ratio (a comparison of the amount of purchases to the equity value in the account) and a comparison of commissions generated within the account to the total dollar value of the account. Both of these measurements were developed largely in the context of equity trading.

With the establishment, in the mid-1970s, of the organized options market,[37] a new opportunity for churning activity was created. Today, just as there are churning violations in equity accounts, there are also churning violations in options accounts. Unfortunately, the measurements of excessive trading that were developed in the equity arena are often not meaningful when applied to options trading. Because the premium price of options is far less than the price of the underlying security, historical turnover ratio numbers, developed in regard to trading in equity securities, have little relevance in measuring churning in options. Turnover ratios also might have limited relevance in measuring churning since option-trading strategies often involve the sale of options contracts by the customer. Such sales of options contracts would not reflect activity in the account unless the positions taken were "closed" through offsetting purchases.[38]

Just as turnover ratios may be of limited value in measuring churning in options accounts, the traditional comparison of total commissions to account value has less meaning in the context of options trading than in equity accounts. This is because the commissions charged in options trading are higher (as a percentage of the amount of money involved in a transaction) than commissions charged in equity trading.[39] In addition, because of the short life of options and the complexity of many option-trading strategies, greater account activity is typically anticipated with

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[37] The SEC approved, in February 1973, the registration of the Chicago Board Options Exchange to trade options securities. Exchange Act Release No. 9985 (Feb. 1, 1973) [1972–1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,212.

[38] Report of the Special Study of the Options Market to the House Comm. on Interstate and Foreign Commerce at 453, Exchange Act Release No. 15,569 (Feb. 15, 1979) (hereinafter *Options Study Report*).

[39] *Id.* at 89.

options trading than with equity trading.[40] Generally accepted measurements for determining excessive trading in options had not been developed by the courts by the time of *McMahon* and *Rodriguez*.[41] Without a method for developing precedent in arbitration, the establishment of such guidelines might now be put off indefinitely.

Example 2. Another area in which creative precedent needs to be developed in the law governing broker/customer relations is in regard to suitability rules as they apply to derivative securities products, such as index options. Trading in derivative securities products poses risks to investors that frequently exceed the risks posed by equity securities. Former SEC Chairman David Ruder, recognizing the dangers inherent in derivative securities trading and in the trading strategies associated with such products, suggested in January 1988 that it might be unacceptable for the average investor to be permitted to engage in trading strategies of certain new securities products, such as selling naked put index options.[42] Assuming, for the sake of argument, that suitability rules should be restructured to prevent brokers from encouraging small investors to participate in certain derivative product trading strategies, how will the arbitration system create this rule? How will the precedent be established?

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[40] The SEC has also noted that the short life of options and the complexity of options trading results in many customers not monitoring their accounts with appropriate diligence. *Options Study Report,* note 38 *supra,* at 440.

[41] A number of commentators have addressed the inadequacy of traditional judicial standards of churning as means of measuring churning in the context of options trading. Packard, "A Test of Churning in Stock Options," 4 Corp. L. Rev. 222, 232–244 (1981); Poser, "Options Account Fraud: Securities Churning in a New Context," 39 Bus. Law. 571 (1984).

[42] Then Chairman Ruder asked:

> Should we, as a regulatory matter, say there are some areas in which we will identify [a] product that is too dangerous for the average investor to engage in? I think of naked put options on the S&P 100 index, which apparently cost a lot of people a lot of money in [the 1987 Market Crash]. There may be some people . . . who shouldn't have the opportunity to engage in these transactions which have a high degree of risk.

Hinden, "Definition of 'Suitable' Investment Elusive," Wash. Post, at F1. (Jan. 7, 1988).

Example 3. A final example of an area in which the arbitration system needs to develop legal precedent relates to punitive damages. While in many instances appellate case law now suggests that punitive damages may be awarded in arbitration,[43] little guidance has been provided as to when such damages are appropriate.[44] Should the same standards apply to granting punitives in an arbitration decision as apply in the judicial decision? Since the awarding of punitive damages is typically intended to serve a public sanction function, does it make sense for the trigger stimuli for punitives to be identical in the two arenas? If the answer is that the standard in arbitration for punitives must be different from the standard in judicial litigation, then what should the standard become in arbitration? More to the point, how will that standard evolve without a precedent-generating mechanism within arbitration?

To identify these three instances or any others in which the arbitration system can benefit from the development of case-generated precedent does not suggest that arbitrators do not currently have sufficient background to respond to new and novel issues of law. Arbitrators traditionally have had and have exercised the authority to fashion creative legal remedies in response to new and changing issues in controversy. But without the benefit of guidelines derived from case-generated precedent, arbitration decisions will definitely lack a uniform response to issues arising out of the same or similar fact patterns, and this lack of predictability can impact on the integrity of the system. Perhaps most importantly, the case law governing

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[43] See Bonar v. Dean Witter Reynolds, Inc., 835 F.2d 1378 (11th Cir. 1988); Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353 (N.D. Ala. 1984), *aff'd,* 776 F.2d 269 (11th Cir. 1985); Willis v. Shearson/American Express, Inc., 569 F. Supp. 821 (M.D.N.C. 1983)); Baker v. Sadisck, 162 Cal. App. 3d 618 (1984). But compare Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354, 353 N.E.2d 793 (1976); and *In re* NYSE Arbitration Between Fahne Stock & Co., Petitioner v. Joseph Waltman, Respondent (S.D.N.Y. 1990), 1940 LEXIS 11024.

[44] A number of commentators have discussed the appropriateness of punitive damage awards in arbitration. See Shell, "The Power to Punish: Authority of Arbitrators to Award Multiple Damages and Attorneys' Fees," 72 Mass. L. Rev. 26 (1987); Carper, "Punitive Damages in Commercial Arbitration," 41 Arb. J. 27 (1986); Penna, "Punitive Damages and Public Policy," N.Y.L.J. 1 (Jan. 14, 1986).

relations between customers and brokers may stagnate and lose its ability to respond dynamically to changes in the world of securities.

Generating Precedent Within the Current Arbitration System

Although SRO rule changes could facilitate the development of case precedent in arbitration, provisions already incorporated within the Code of Arbitration Procedure (CAP) can be utilized in order to create such precedent. There are several alternative methods by which such precedent can be generated in a manner compatible with the current stucture of the SRO rules.

First Alternative

CAP does not require arbitrators to prepare reasoned opinions, but it also does not prohibit the preparation of such opinions.[45] Arbitrators do currently write reasoned opinions, albeit, infrequently.[46] The SEC, in approving the 1989 Rules Amendments, determined that it was not appropriate to require reasoned opinions.[47] The SEC indicated that it would "await any independent development on the part of arbitrators themselves to develop written opinions."[48] In explaining its wait-and-see outlook, the SEC noted that "[i]n the labor area, arbitrators have voluntarily developed a practice of writing opinions in order to help themselves understand developments in the labor arena."[49]

The preparation of a reasoned opinion, even when made publicly available, would not, in and of itself, serve to generate precedent. If the SROs circulated such opinions within their pool of arbitrators, these opinions might well influence future arbitrations. The real

[45] While NASD CAP Rule 41(e) does not require arbitrators to include reasons within their written awards, it does not restrict the right of arbitrators to include such reasons.

[46] Discussions between David A. Lipton and NASD Director of Arbitration Deborah Masucci (Apr. 1990).

[47] The SEC stated that it "would not be appropriate at this time to require the inclusion of written opinions in awards." 1989 Rules Amendments Adoption Release, note 10 *supra*, at 80,109.

[48] *Id.*

[49] *Id.*

benefit of reasoned opinions, however, at least for purposes generating precedent, arises if and when the awards associated with such opinions are appealed. To the extent that the award and the accompanying opinion are upheld in such appeals and are found to be not in "manifest disregard" of the law,[50] the arbitrators' opinion becomes incorporated into appellate case law precedent.

Arbitrators should not casually resort to including written opinions into their awards in order to stimulate case-generated precedent. The inclusion of such opinions in the award potentially places a burden on the parties, as well as upon the arbitration system itself. The drafting of such an opinion might delay the issuance of an award because of the time it takes to prepare the opinion. Further, drafting opinions might impede the ability of arbitrators to reach a consensus when the arbitrators are in agreement as to the amount of an award but not as to the basis of the award. In addition, once a reasoned opinion is written, there is an increased likelihood that an appeal will be made by one of the parties on the basis of manifest disregard of the law. Obviously, the taking of an appeal will delay the closure of the particular dispute that prompted the arbitration. Part of the very essence of arbitration, its expeditiousness, might well be sacrificed when a reasoned opinion is prepared.[51] The arbitrator will have to balance the need for and the desirability of case-generated precedent against the burdens that the preparation of such opinions might impose.

Second Alternative

There is a more direct method available to arbitrators for generating case precedent than the preparation of a reasoned opinion that results in an appeal. Section 16 of CAP permits the arbitrators to

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[50] The meaning of the term "manifest disregard of the law" is not entirely clear. In order to find such a disregard of the law, however, most circuits require that the arbitrators must essentially understand the law and then reject it. Mere error or failure to understand or apply the appropriate law is generally not sufficient. See Lipton, "Standard on Which Arbitrators Base Decisions," 16 Sec. Reg. L.J. (1988).

[51] The SEC has noted that requiring reasoned opinions could "slow down the arbitration process and discourage many persons from participating as arbitrators." 1989 Rules Amendments Adoption Release, note 10 *supra*, at 80,110.

dismiss a proceeding on their own initiative and to refer the parties to their remedies provided by applicable law.[52] Such remedies include litigation. *The Arbitrator's Manual* directs that arbitrators may consider using their authority to dismiss a case when the case involves "substantial legal issues for which the establishment of a legal precedent is important." Thus, when arbitrators perceive that a matter before them involves issues for which legal precedent needs to be generated, the rules of the SRO permit the arbitrators to send such matter to a judicial forum. Again, while CAP provides the authority for arbitrators to dismiss matters, the need to exercise such authority to generate case precedent must be balanced against the interest the parties have in satisfying their commercial expectation of resolving their disputes in arbitration. Of course, when both parties to an arbitration request dismissal of the matter, the arbitrators are compelled to comply.[53]

Third Alternative

Case precedent may also be prompted by the parties to the arbitration themselves. If both sides in an arbitration request a reasoned opinion by the arbitrators, the NASD arbitration staff advises the arbitrators to not arbitrate the matter unless they are prepared to provide such an opinion.[54] The NASD staff also recommends that even when only one party to an arbitration requests a written opinion, the arbitrators should give serious consideration to providing such an opinion. Again, these arbitrator opinions may generate precedent when the associated awards are appealed on the basis of manifest disregard of the law.

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[52] NASD CAP § 16 reads as follows:

> At any time during the course of an arbitration, the arbitrators may either upon their own initiative or at the request of a party dismiss the proceeding and refer the parties to the remedies provided by applicable law. The arbitrators shall at the joint request of all the parties dismiss the proceedings.

[53] See NASD CAP § 16.

[54] Discussions between David A. Lipton and NASD Director of Arbitration Deborah Masucci (Apr. 1990).

Conclusion

The brave new world of arbitration post–*McMahon/Rodriguez* is still emerging. Other than an infrequent resort to a reasoned opinion, arbitrators have not yet begun to act to establish precedent through opinion writing or Section 16 actions. It is not at all clear that arbitrators will take on this task in the near future. If arbitrators do not exercise the authority presently available to them to assist in the generation of precedent, it might ultimately prove necessary for the SROs to play a more active role in the process of generating precedent. SROs may need to develop a system for identifying important legal issues for which precedent needs to be generated and then for the SRO's to select out appropriate controversies to be sent to judicial litigation in order for case-generated guidelines to be established.

What is clear today is that the post–*McMahon/Rodriguez* world of securities arbitration is different from the world of securities arbitration that preceded these decisions. The arbitration system is still responding to the changes that resulted from these decisions. One of those changes is a significantly diminished production of case-generated precedent covering broker/customer relationships. The success of the securities arbitration program will continue to be highly dependent on the ongoing cooperation, creativity, and thoughtfulness of its arbitrators in responding to these changes.